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In the Supreme Court of the United States

OCTOBER TERM, 1926

No. —

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, Petitioner

v.

MILTON DAIRY COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

The Solicitor General, on behalf of L. M. Willcuts, Collector of Internal Revenue for the District of Minnesota, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit entered in the above case on September 25, 1926, reversing the judgment of the United States District Court for the District of Minnesota.

QUESTION PRESENTED

In computing the invested capital of a corporation for the fiscal years 1919 and 1920, under Section 326 of the Revenue Act of 1918, can invested

capital be increased by the amount of net earnings for the fiscal years 1918 and 1919, where there existed at the beginning of the fiscal year 1918 an operating deficit of $70,296.12, and the net earnings for the years 1918 and 1919 were only $34,397.40, or should such net earnings first be applied to offset an existing operating deficit before there can be any surplus or undivided profits to be added to invested capital?

THE STATUTE

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1092:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section);
>
> (1) Actual cash bona fide paid in for stock or shares;
>
> (2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided,* That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and ad-

dress of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided,* That in no

case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

TREASURY REGULATIONS

Regulations 45 (1920 Edition), Article 838:

Surplus and undivided profits; earned surplus.—Only true earned surplus and undivided profits can be included in the compu-

tation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.

Regulations 45 (1920 Edition), Article 860:

Impairment of Capital.—Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except where there has been directly or in-

directly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital.

STATEMENT OF THE FACTS

The Milton Dairy Company, hereinafter referred to as the Company, is a Minnesota corporation, and L. M. Willcuts, petitioner, at all times hereinafter mentioned, was Collector of Internal Revenue for the District of Minnesota. The company kept its books on a basis of a fiscal year ending on the last day of February each year. The company filed a corporation income and profits-tax return for the fiscal year ending February 28, 1919, and included in its invested capital the sum of $11,489.26, alleged to be profits for the fiscal year 1918 remaining in the business and included in its invested capital for the fiscal year ending February 28, 1920, the additional sum of $22,908.14 alleged to be profits for the fiscal year 1919 remaining in the business. During the fiscal years 1918 and 1919 there had been no distribution of profits to the stockholders of the company. On February 28, 1917, at the beginning of the fiscal year 1918, the company had an impairment of capital resulting from an operating deficit of $70,296.12, which was in excess of the so-called profits for the fiscal years 1918 and 1919.

The Commissioner allowed as invested capital the sum of $145,817.04, which amount represented capital actually paid in prior to February 28, 1917.

The Commissioner excluded from invested capital the sums of $11,489.26 and $22,908.14, the operating profit for 1918 and 1919, on the ground that said sums must first be applied to make good the impairment of capital resulting from the operating deficit before there could be any surplus or undivided profits, to be treated as invested capital. Additional taxes were assessed and paid under protest for each of said fiscal years, and claims for refund in the sum of $1,274.30 for the fiscal year 1919, and $529.89 for the fiscal year 1920, were duly filed and rejected, whereupon this suit was instituted.

SPECIFICATION OF ERROR TO BE URGED

The court erred in holding that under Section 326 of the Revenue Act of 1918 the invested capital of a corporation can be increased by alleged earned surplus or undivided profits where there exists an operating deficit in excess thereof.

REASON FOR GRANTING THE PETITION

(1) The Circuit Court of Appeals has misconstrued Section 326 of the Revenue Act of 1918 in holding that invested capital can be increased by earnings where these earnings are insufficient to offset an existing operating deficit.

(2) The decision of the Circuit Court of Appeals is contrary to the decision of this Court in *Edwards* v. *Douglas,* 269 U. S. 204, in which it was held that surplus represents excess of assets over liabilities.

(3) A proper construction of Section 326 of the Revenue Act of 1918 is fundamental in auditing many thousands of corporation returns for excess-profits-tax purposes for the years 1917 to 1921, inclusive, and the opinion of the Circuit Court of Appeals overrules the settled practice and rulings of the Treasury Department since the passage of the first excess profits tax law, and affects a large number of cases not finally closed.

(4) This case is one of importance, both to the Government and to all corporations which filed excess-profits-tax returns, as the principle announced by the Circuit Court of Appeals changes the long-established and accepted practice of the Treasury Department and the basis generally adopted by the taxpayers in filing returns.

(5) The decision of the Circuit Court of Appeals is contrary to the uniform decisions of the United States Board of Tax Appeals, which results in the Board finding that additional taxes are due and must be paid, while the court rules that the same kind of tax must be refunded.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Eighth Circuit should be granted.

WILLIAM D. MITCHELL,
Solicitor General.

DECEMBER, 1926.

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the District Court (R. 13) is reported in 8 F. (2d) 178. The opinion of the Circuit Court of Appeals (R. 31) has not been reported.

JURISDICTION

The judgment of the Circuit Court of Appeals to be reviewed was entered September 25, 1926. (R. 35.) Jurisdiction to issue the writ is found in the Act of February 13, 1925 (c. 229, 43 Stat. 936).

STATEMENT

A statement of the question presented and of the facts, and copies of the applicable statutes will be found in the petition.

ARGUMENT

UNDER SECTION 326 OF THE REVENUE ACT OF 1918 THERE CAN BE NO ADDITION TO INVESTED CAPITAL BY WAY OF SURPLUS OR UNDIVIDED PROFITS UNTIL NET EARNINGS HAVE EXCEEDED THE AMOUNT OF AN EXISTING OPERATING DEFICIT

In the case at bar it is agreed that the paid-in invested capital of the Company for the fiscal year 1918 was $145,817.04. (R. 13, 23.) The Company contends that it is entitled to add to this paid-in invested capital the full amount of earnings for the fiscal years 1918 and 1919, as profits remaining in the business, although those earnings were insufficient to offset an actual existing operating defi-

cit and impairment of capital as of the beginning of the fiscal year 1918. The Government contends that under Section 326 (a) (3) of the Revenue Act of 1918, until the earnings exceed a previous operating deficit there is no true earned surplus or undivided profits to increase invested capital.

Section 326 of the Revenue Act of 1918 is a statutory definition of what shall constitute "invested capital." The definition is both inclusive and exclusive. *LaBelle Iron Works* v. *United States,* 256 U. S. 377. It includes certain assets and excludes others. It excludes certain elements which in the ordinary sense are considered "capital." It is not synonymous with money used in the business for it excludes by the express words of the statute "borrowed capital" and "surplus and undivided profits earned during the current year."

It is submitted that the error of the Circuit Court of Appeals lies in the assumption that "invested capital" is synonymous with "money used in the business."

There is no true surplus and undivided profits within the meaning of Section 326 (a) (3) until earnings exceed the amount of an operating deficit.

Invested capital consists of—

(*a*) Cash *paid in* for stock or shares.
(*b*) Cash value of tangible property *paid in* for stock or shares.
(*c*) *Paid in* surplus.
(*d*) Earned surplus or undivided profits.
(*e*) A certain part of the value of intangible property *paid in* for stock or shares.

Thus the property which may be included in invested capital falls into one of two classes: (1) money and property *paid in,* or (2) earned surplus and undivided profits.

There is no question as to the invested capital of the company as of February 28, 1918. Its invested capital then was $145,817.04, that being the amount previously paid in and allowed by Article 860 of Regulations 45 (1920 Edition). That article has nothing to do with the controversy in this case. It refers only to " paid in " capital and holds that this can not be reduced. The regulation is based upon the decision of the Court in *LaBelle Iron Works* v. *United States,* 256 U. S. 377, and carries out the principle announced in that decision that " paid in " capital is a constant quantity not affected by either subsequent appreciation or depreciation in value. The sole question in the case at bar relates to an *addition* to invested capital of alleged earned surplus and undivided profits represented by the amounts earned in 1918 and 1919. Article 838 of Regulations 45 does not permit such addition because there can be no earned surplus and no undivided profits so long as there is an operating deficit.

In *Edwards* v. *Douglas,* 269 U. S. 204, this Court held (p. 214):

> The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock.

In *Insurance Company of North America* v. *McCoach,* 218 Fed. 905, 908, affirmed in *McCoach* v.

Insurance Company of North America, 244 U. S. 585, the Court said:

> The real surplus of a corporation is, of course, the difference between the aggregate value of all its assets and the sum of all its liabilities, including capital stock.

In *Leather Manufacturers National Bank* v. *Treat,* 116 Fed. 774, 775, 776, the court held:

> The only question presented is whether the word "surplus," * * * is to be construed as having some restricted meaning, or in its natural and ordinary sense, as including the entire overplus of assets over liabilities. * * * It would seem, rather, that Congress used the word "surplus" in its ordinary sense, as indicating the amount left over after setting aside sufficient of the assets of a banker to meet his liabilities.

The earnings in this case were not "in excess of all liabilities." There was no surplus, but an operating deficit.

There were no undivided profits, as that term signifies profits which may be but have not been divided among stockholders and which pass to "surplus" if not divided at the end of the year. The current profits in this case could not legally be divided. A distribution would further impair a capital account already impaired.

The definition of "undivided profits" approved by this Court in *Edwards* v. *Douglas,* 269 U. S. at page 214, footnote 4, is:

> Undivided profits.—Earnings or profits which have not been divided among the partners in a firm or the stockholders in a corporation.

There is, therefore, neither an earned surplus nor undivided profits, such as the statute contemplates may be added to paid-in capital for the purpose of increasing invested capital.

It is submitted that the company could not have a true earned surplus or undivided profits until the earnings exceeded the accumulated operating deficit. If the company in the case at bar had earnings prior to February 28, 1917, of approximately $34,000 and had thereafter sustained an operating deficit of $70,000 it would be absurd to state that the company had a surplus or undivided profits of $34,000. It is submitted that the conclusion can not be changed by a reversal of the controlling events.

Article 838 of Regulations 45 (1920 Edition) is a pronouncement of the fundamental economic principle that a surplus and a deficit can not exist at the same time. The regulation has been consistently followed by the Treasury Department and has been generally accepted as correct by taxpayers in filing excess-profits-tax returns.

The United States Board of Tax Appeals has approved it. See *Long Beach Development Co.* v. *Commissioner of Internal Revenue,* dated November 23, 1926 (not yet reported), *Gould Coupler Co.* v. *Commissioner of Internal Revenue,* dated No-

vember 16, 1926 (not yet reported), and *Appeal of Valdosta Grocery Company*, 2 B. T. A. 727.

CONCLUSION

It is apparent that because of an admitted operating loss which left its capital impaired, the respondent did not have a true earned surplus or undivided profits during the years in question and should not be allowed to increase its invested capital under the provisions of Section 326 (a) of the Revenue Act of 1918, and that the judgment of the District Court was right. Any artificial construction of the phrase "surplus or undivided profits" in Section 326 (a) which leads to the conclusion that a corporation whose capital is impaired by operating losses can have surplus or undivided profits available to increase its invested capital seems utterly untenable. While this statute has been repealed, many cases, not finally closed, are affected.

In view of the fact that the question here involved is of importance in the administration of the revenue laws, it is respectfully submitted that the petition for writ of certiorari should be granted.

WILLIAM D. MITCHELL,
Solicitor General.

A. W. GREGG,
General Counsel, Bureau of Internal Revenue.

J. R. WHEELER,
Special Attorney.

DECEMBER, 1926.

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